Cytonn Weekly Report #28

Cytonn Weekly

Executive Summary

- **Fixed Income:** There was a mixed trend on treasury bills this week, with the 91 and 182-day increasing to 7.6% and 9.9%, respectively, while the 364-day declined to 10.7%. The International Monetary Fund released a report on Fiscal Transparency in Kenya, highlighting key areas of improvement;
- **Equities:** During the week the Kenyan equity market closed on a downward trend with NASI, NSE 20 and NSE 25 declining by 1.9%, 2.5%, and 2.5%, respectively. The Nairobi Securities Exchange has been formally recognized as a Self-Regulatory Organization;
- **Private Equity:** Technology and financial sectors continue to attract private capital in the Sub-Saharan region as CDC and DEG inject EUR 50.0 mn and Kshs. 1.4 bn in Africa Internet Group (AIG) and Zep-Re, respectively;
- **Real Estate:** Commercial Bank of Africa announced its partnership with Bamburi Cement to provide affordable housing ranging from Kshs 0.5 mn to Kshs 4.5 mn through a mortgage arrangement. The affordable housing will be achieved by using the Expanded Polystyrene Panel (EPS) technology.

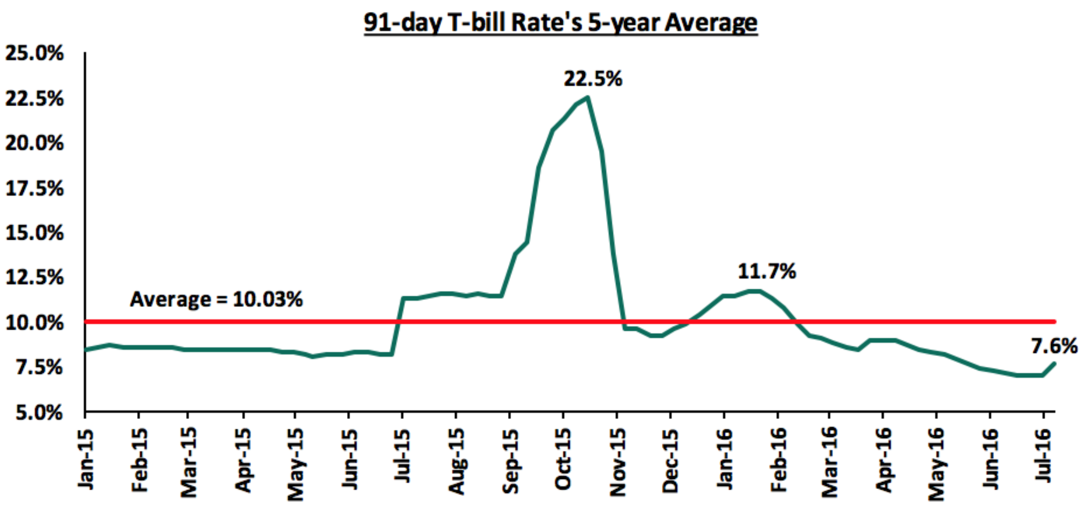
Company Updates

- We formally launched our entry-level training program, Cytonn Young Leaders Program, ?CYLP?, on 15th July 2016 at Sarova Panafric Hotel. Through CYLP, we have trained 180 university graduates since its inception two years ago, and we have made employment offers to 60 of the program participants. CYLP is both an entry-level talent attraction tool for Cytonn, for those we hire into the firm, and also a way to giving back, by training those that proceed to work elsewhere. ?This program is a key strategic advantage for us, with 50% of our current workforce consisting of fresh university graduates trained thorough CYLP. Unlike most employers, we actually like people without experience. Our CYLP graduates are highly talented and driven. We give them enormous responsibilities in our high performing culture. They are one of the key drivers of our rapid growth,? said Edwin H. Dande, Managing Partner, Cytonn Investments. ?The program is very competitive. For our popular programs such as the Investments Program, the success rate is 1.1%. To put it into context, it is a lot harder to get into CYLP than to get into some of the world?s top universities like Harvard and Princeton, with success rates of about 5.5%,? added Edwin. For more information on CYLP and on the launch: CYLP Launch.
- Cytonn Investment Co-operative membership recruitment drive is still on. For more information, please see the link: Cytonn Cooperative
- To invest in any of our current or upcoming real estate projects, please visit Cytonn real estate. We continue to see very strong interest in our products, particularly The Alma, which is now 50% sold and has delivered an annualized return for 55% p.a. for investors who bought off-plan. We have 12 investment ready projects, offering attractive development returns and buyer's returns of a minimum of 25% p.a. See further details here: Summary of investment ready projects
- We continue to beef up the team with several ongoing hires: Careers at Cytonn.

Fixed Income

During the week, T-bills were undersubscribed for the 3rd week, though there was an increase in the performance rate to 82.1%, from 36.4% recorded last week. This was a significant improvement owing to subscriptions for the 91, 182 and the 364-day increasing to 80.5%, 50.2% and 115.1%, respectively, compared to 48.9%, 46.3% and 18.1% recorded the previous week. Yields for the 91-day and 182-day increased to 7.6% and 9.9% from 7.0% and 7.6%, respectively, while the 364-day yield declined by 10 bps to 10.9% from 11.0% the previous week. Of interest is the high subscription rate of the 364-day, with a decline in rates on the same, and we shall investigate further why this is the case given that the number of bidders were also much fewer, which is an indication of more corporate participation on the paper.

The 91-day T-bill is currently trading below its 5-year average of 10.0%, having witnessed a downward trend in the last two months. The downward trend for the 91-day paper has reversed and we are witnessing upward pressure on the rates due to pressure on Government borrowing given the new fiscal year, which has been characterized by an uptick in inflation.



This week, Government issued 2 bonds, a 5-year bond (FXD 2/2016/5) and a reopened 20-year bond (FXD 1/2008/20) with a time to maturity of 12 years, for the purpose of budgetary support. Given (i) pressure on Government to finance the 2016/2017 budget, and (ii) low liquidity in the money market owing to CBK?s mop up activities through repos to anchor inflationary pressures, we expect upward pressure on interest rates. Therefore we advise investors to bid between 13.0% and 14.0% for the 5-year and between 14.0% and 15.0% for the 20-year bond with more bids towards the latter.

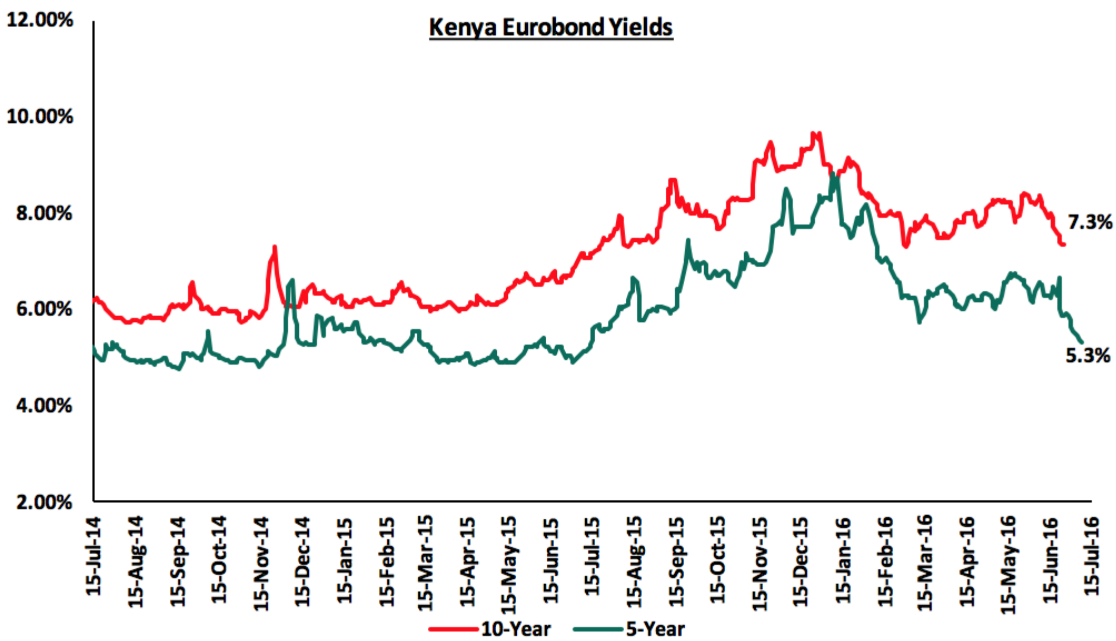
The Central Bank weekly report revealed that the interbank rate decreased by 230 bps to 6.4%, from 8.7% the previous week, despite a net liquidity reduction of Kshs 1.6 bn in the money market. The liquidity reduction was as a result of the CBK?s mop up activity through repos worth Kshs. 15.0 bn to anchor inflationary expectations and to protect the shilling as highlighted in our Cytonn Report #27. In our view, the interbank rate is often determined by the liquidity distributions within the banking sector as opposed to the net amount. This is further an indication that all banks do not trade freely with each other in the market. The repo rate is currently at 9.0%, which is higher and more attractive compared to the interbank rate at 6.4%.

Below is a summary of the money market activity during the week:

all values in Kshs bn, unless stated otherwise			
Weekly Liquidity Position - Kenya			
Liquidity Injection		**Liquidity Reduction**	
Term Auction Deposit Maturities	8.6	T-bond sales	0.0
Government Payments	12.2	Transfer from Banks - Taxes	22.2

T-bond Redemptions	0.0	T-bill (Primary issues)	5.8
T-bill Redemptions	8.4	Term Auction Deposit	0.0
T-bond Interest	0.0	Reverse Repo Maturities	10.6
Repos Maturities	17.9	Repos	15.0
Reverse Repo Purchases	4.9		
Total Liquidity Injection	**52.0**	**Total Liquidity Withdrawal**	**53.6**
		Net Liquidity Reduction	**(1.6)**

According to Bloomberg, yields for the 5-year and 10-year Eurobonds issued in 2014 declined week on week by 0.5% and 0.4%, to 5.3% and 7.3%, respectively, from 5.8% and 7.7% last week, respectively. Since the mid ? January 2016 peak, yields on Kenyan Eurobond have declined by 3.5% and 2.3% on account of improving macroeconomic conditions and the recent cooling of political temperatures since the ruling coalition and the opposition coalition started discussions around electoral reforms, causing the opposition coalition to cease street protests. The investment community is keen that discussions lead to a resolution to avoid any further chaos and disruptions.



The Kenya Shilling depreciated slightly against the dollar by 0.2% this week, to close the week at 101.3, compared to 101.2 the previous week, driven by dollar demand from importers and the strength of the dollar in the international markets. There was a slight decline in the forex reserves from 5.15 months to 5.13 months of import cover, and this can be attributed to the Central Bank seeking to intervene in support of the currency.

During the week, Fitch Ratings downgraded their rating on Kenya Shilling due to high exposure to external exchange rate movements from the high exposure to foreign debt. Kenya's Long-Term Foreign Currency Issuer Default Rating (IDR) has been maintained at 'B+' and the Long-Term Local Currency IDR downgraded to 'B+' from 'BB-' with the outlook remaining negative. The ratings on Kenya's senior unsecured Foreign-Currency bonds have also been affirmed at 'B+'. The Country Ceiling has been affirmed at 'BB-' and the Short-Term Foreign Currency IDR at 'B'. The rationale for this rating is that (i) as per the FY 2016/17, Kenya continues to increase capital expenditure despite fiscal deficits which Fitch projects to be at 8.6% of the GDP, which is above their ?B? median of 4.2%, and (ii) high allocation to external borrowing at 66.7% of the total borrowing for fiscal year 2016/17. On an YTD basis, the shilling has appreciated against the dollar by 0.9%. We believe despite this setback, the shilling will remain stable for the remainder of the year supported by (i) the high levels of foreign exchange reserves currently at USD 7.8 bn, equivalent to 5.1 months of import cover, and (ii) improved diaspora remittances, with cumulative 12 months? inflows to May 2016 increasing by 11.1% to USD 1.6 bn from USD 1.5 bn in the year to May 2015. Kenya has increased their foreign debt exposure over the last few years, however with a debt-to-GDP of 50% we are well within sustainable levels prescribed for a frontier and emerging country by IMF. Given the expansionary stage Kenya is currently in, we do not expect any changes to the import export structure soon, but with the high forex reserves of 5.1 months, the Central Bank can intervene in case of any currency fluctuations.

The International Monetary Fund (IMF) has released a report evaluating the fiscal transparency in Kenya. The report summarized the assessment of Kenya?s performance against 36 fiscal transparency principles of the Fiscal Transparency Code. In general, Kenya had 7 principles that were ?Not Met?, 16 ?Basic?, 7 ?Good? and 6 ?Advanced?. According to the report, the introduction of the county government system in 2010 and the first Eurobond issue in 2014 are among the factors that highlight the importance of fiscal transparency and prompted the need for changes in the country?s public financial management framework. Despite the improvements made, we still have (i) 28.0% of direct government expenditure remaining unreported as only the Central Government and a few counties are covered in terms of fiscal reporting, (ii) discrepancies of 1.7% of GDP between financing averages and fiscal balances making account reconciliation difficult, (iii) 1.1% of GDP in unexplained stock flow adjustments, (iv) financial statements getting produced but rarely audited or published showing lack of transparency, and (v) liabilities of about 43.0% of GDP remaining outside fiscal reports and are therefore unaccounted for. In light of this, the IMF maintains the view that the National Treasury has the capabilities to improve on the above mentioned metrics. In our view, this is an eye-opening report, and calls on the Government of Kenya to do better in terms of fiscal transparency.

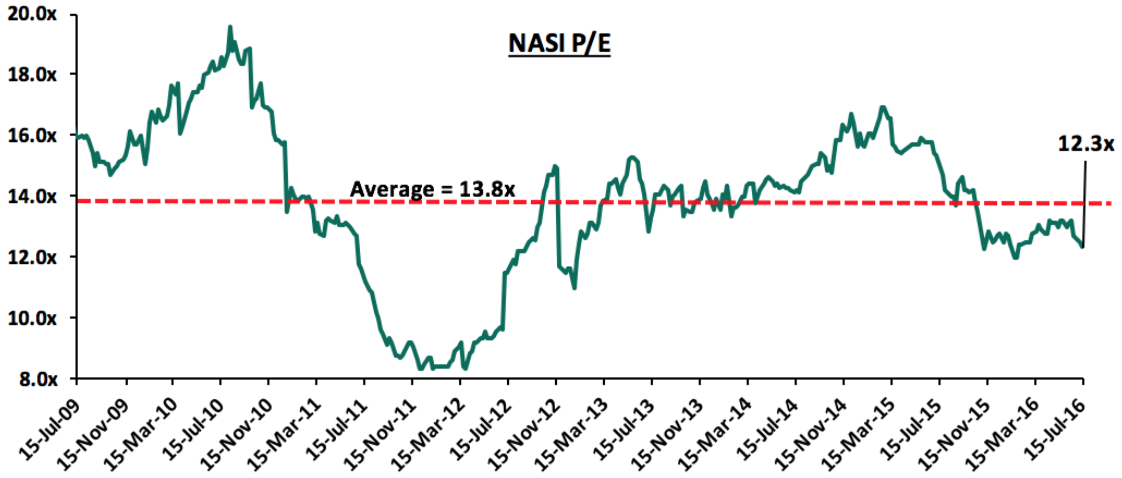
The government has had a slow start to the financial year having a deficit Kshs 11.9 bn for the current fiscal against a target of Kshs 13.2 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 229.6 bn budgeted for the full financial year). Interest rates have bottomed out and we are currently witnessing some upward pressure on interest rates given (i) pressure on Government to start financing for the budget, and (ii) low liquidity given central bank?s mop up activities in the money market to anchor inflationary expectations. It is due to this that we advise investors to be biased towards short to medium-term papers.

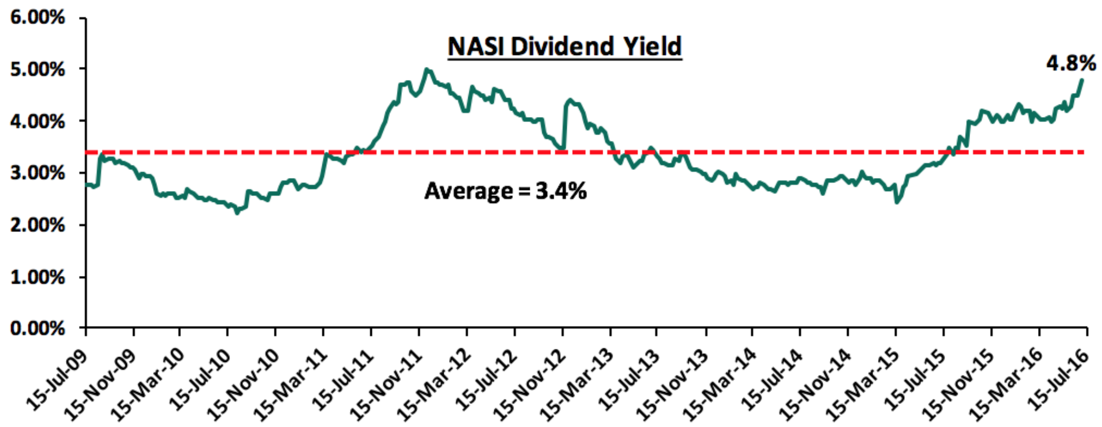
Equities

During the week, the Kenyan equity market closed on a downward trend with NASI, NSE 20 and NSE 25 declining by 1.9%, 2.5%, and 2.5%, respectively, with the YTD performance coming in at -5.1%, -11.0%, and -7.3%, respectively. This week?s performance was as a result of decline in large cap stocks with Equity Group (3.8%), KCB Group (3.7%), Safaricom (3.0%) and East Africa Breweries (1.8%) all declining. Since the February 2015 peak, the market has lost 34.6% and 22.1% for NSE 20 and NASI, respectively.

Equities turnover rose by 16.5% to close at Kshs 3.1 bn from Kshs 2.7 bn the previous week?s close, with foreign investors? net buyers, with net inflows of USD 217,000, compared to a net outflows of USD 68,000 recorded the previous week. As Q3?2016 starts, we expect companies to start releasing their half-year results, which is expected to drive market activity. We maintain our expectation of stronger earnings growth in 2016 compared to 2015, with an estimated growth of 12.5%, supported by a favorable macroeconomic environment. Given the low valuations, long-term investors should gradually be taking positions in the market.

The market is currently trading at a price to earnings ratio of 12.3x, versus a historical average of 13.8x, with a dividend yield of 4.8% versus a historical average of 3.4%. The charts below indicate the historical PE and dividend yields of the market.





The Nairobi Securities Exchange (NSE) having successfully separated its commercial and regulatory functions? management structures, has been formally recognized by the Capital Markets Authority (CMA) as a Self-Regulatory Organization (SRO) with the mandate to: (i) establish rules governing conduct of derivatives, members and clients, (ii) monitor compliance by supervising members and markets, (iii) regulate NSE clearing and settlement systems, and (iv) list new offers, monitor compliance of set obligations by capital raising companies in the market and admission and oversight of trade participants. An SRO is a private institution that has the mandate to exercise a portion of rules or directives maintained by an authority over an industry; either to compliment some form of government regulation or to fill a vacuum or oversight of a regulatory body.

Some of the benefits that SROs bring to the table are outlined below:

i. SROs can react quicker than regulators to developments in the securities market thus not impeding market growth and flexibility through constricting regulations and time lags,
ii. Self-regulation allows resources and expertise available from market players to be used in regulating markets. Industry professionals can apply their expertise to regulation of complicated fields such as derivatives, and,
iii. SROs are known to set and enforce higher standards for the industry players than those required by government regulatory bodies, hence ensuring that compliance is well monitored and integrity is maintained.

While recognizing that SROs are a value-add, there are a few risks involved with SROs such as: (i) conflict of interest: failure to strike a balance between sound regulatory standards and the need to promote vibrant activity in the market, and (ii) introduction of another layer of regulation: regulation by SRO and continued oversight by the government may increase regulatory burden of cost and complexity on capital markets. In our view, the NSE being recognized as an SRO is a positive step in terms of ensuring there is flexibility in the capital markets. Given the recent launching of two REITs, the Stanlib I-REIT and the Fusion D-REIT, and now the SRO initiative, we are seeing an increasing trend by the CMA to evolve and innovate the capital markets; these initiatives are commendable as they are crucial to deepening our markets and attracting capital that is needed to fund investments, grow the economy, create jobs and uplift the standards of living.

British American Tobacco (BAT) Kenya released HY?2016 results recording a 10.7% growth in core earnings per share to Kshs 21.5 from Kshs 19.4 in HY?2015 driven by a decline in expenses by 4.3% compared a marginal 1.0% decline in net revenues. BAT announced an interim dividend of Kshs 3.5 the same amount paid in HY?2015. BAT continues to operate in a highly regulated environment, with constant upward review of excise tax continuing to suppress margins. However, the company has consistently grown its revenue base while keeping costs low. We are currently finalizing on our valuation of BAT, and we shall publish our recommendation on 24th July 2016.

Kenya Airways (KQ) has received a Kshs 10.0 bn bridging loan from the Kenyan Treasury. Treasury secured the facility from the African Export-Import Bank (Afriexim Bank) on behalf of KQ, aimed at easing cash-flow constraints. In 2015, Afriexim bank agreed to lend up to Kshs 20 bn to KQ through a government backed bridging facility. KQ has remained stuck in losses, driven by a slowdown in revenue growth and a high levels of operational expenses, which has seen it cut down on the number of staff, and sell off non-core assets to lower costs and improve cash-flows, respectively. The step by the Treasury ? Government to bailout KQ demonstrates the overall commitment to protect (i) shareholder?s value, (ii) sustain and maintain a national brand and pride, and (iii) support local businesses that are dependent on KQ. However, while the bailout provides some short-term relief, it is not clear that the long-term, deep seated strategic, financial and managerial challenges that culminated into the current financial dire straits at KQ have been dealt with.

Liberty Kenya announced that it is considering as many as 10 acquisitions among Kenya insurers as part of its 5-year strategy, in order to increase its foothold in East Africa. The insurance market in Kenya has remained competitive, despite sluggish growth and low insurance penetration. The Insurance Regulatory Authority is implementing new risk based capital requirements based on the nature of business carried out by the insurers to try and match the risk activities of organizations to their core-capital. As highlighted in our Listed Insurance FY?2015 Report, we expect that there will be increased regulation in the sector, as well as increased consolidation to reduce duplication of products by insurance companies. These efforts will improve revenue channels for insurance firms and ensure strong and well-capitalized insurance companies.

During the week, Uchumi Supermarkets (Uchumi) made payments of Kshs 240 million of outstanding supplier debt for May and June deliveries. The payment comes after Uchumi faced a winding up crisis with suppliers moving to court to force the retailer to pay up on back-dated debts worth Kshs 3.6 bn. The payment has been made through an escrow account jointly operated by the suppliers. Uchumi continues to make efforts to improve daily liquidity and cash-flows, which earlier led to cut in supplies to its stores. We maintain our view that Uchumi?s success going forward will be hinged on its ability to (i) implement its turnaround strategy, and (ii) pay off its suppliers to avoid winding up the company.

Below is our equities recommendation table. Key changes from our previous recommendation are;

- Liberty Kenya has moved from an ?Accumulate? recommendation, with an upside of 15.8% to a ?Buy? recommendation with an upside of 22.4%, following a 5.4% w/w price decline
- Britam has moved from a ?Sell? recommendation, with a downside of 0.8% to a ?Lighten? recommendation with an upside of 4.5%, following a 5.2% w/w price decline.

all prices in Kshs unless stated

EQUITY RECOMMENDATION

No.	Company	Price at 08/07/16	Price at 15/07/16	w/w Change	YTD Change	Target Price*	Div. Yield	Upside/ (Downside)**	Recommendation

1.	KCB Group***	33.5	32.3	(3.7%)	(26.3%)	49.4	5.6%	58.8%	Buy
2.	Kenya Re	19.5	19.8	1.5%	(5.7%)	26.7	3.5%	38.3%	Buy
3.	Centum	45.0	43.8	(2.8%)	(5.9%)	57.2	2.1%	32.8%	Buy
4.	DTBK***	170.0	167.0	(1.8%)	(10.7%)	204.2	1.4%	23.7%	Buy
5.	Liberty	14.9	14.1	(5.4%)	(27.9%)	17.2	0.0%	22.4%	Buy
6.	Barclays	10.0	10.1	0.5%	(26.1%)	10.9	9.7%	18.2%	Accumulate
7.	HF Group	19.9	19.6	(1.5%)	(11.9%)	21.6	7.5%	17.7%	Accumulate
8.	Equity Group	39.8	38.3	(3.8%)	(4.4%)	42.1	5.4%	15.5%	Accumulate
9.	Co-op Bank	16.4	15.2	(7.3%)	(15.6%)	16.0	4.3%	9.6%	Hold
10.	NIC	35.8	34.0	(4.9%)	(21.4%)	35.7	2.7%	7.7%	Hold
11.	CIC Insurance	4.7	4.5	(5.3%)	(28.2%)	4.7	1.9%	7.5%	Hold
12.	Standard Chartered***	205.0	210.0	2.4%	7.7%	208.6	6.1%	5.4%	Hold
13.	Pan Africa	39.0	37.0	(5.1%)	(38.3%)	39.0	0.0%	5.4%	Hold
14.	CfC Stanbic	80.0	80.0	0.0%	(3.0%)	83.6	0.0%	4.5%	Lighten
15.	Britam	14.5	13.8	(5.2%)	5.8%	14.1	1.9%	4.5%	Lighten
16.	I&M Holdings	109.0	109.0	0.0%	9.0%	109.5	3.5%	4.0%	Lighten
17.	Safaricom	17.6	17.4	(1.1%)	6.4%	16.6	4.2%	(0.0%)	Sell
18.	Jubilee Insurance	470.0	489.0	4.0%	1.0%	477.8	1.8%	(0.5%)	Sell
19.	NBK	9.6	9.5	(1.0%)	(39.7%)	5.4	0.0%	(43.2%)	Sell

****Target Price as per Cytonn Analyst estimates***

*****Upside / (Downside) is adjusted for Dividend Yield***

******Indicates companies in which Cytonn holds shares in***

Accumulate ? Buying should be restrained and timed to happen when there are momentary dips in stock prices.

Lighten ? Investor to consider selling, timed to happen when there are price rallies

We are neutral with a bias to positive on Equities given the higher earnings prospects, supported by a favorable macroeconomic environment.

Private Equity

UK development finance institution CDC, has injected EUR 50.0 mn (USD 55.5 mn) in Africa Internet Group (AIG), a parent group of 10 fast growing companies in more than 23 African countries including Jumia, Easy Taxi, Hellofood, Jovago, Lamudi and Kamyu. AIG?s e-commerce businesses have already cemented themselves in the African market, across all sectors including online shopping, restaurants, real estate and transport, all developed to increase availability of products through mobile and web access. The funding from CDC will enhance AIG?s presence in Africa, and allow AIG through its chain of fast growing companies expand its operations thus (i) creating jobs across the continent, and (ii) expanding market base for small businesses. AIG?s growth success, being an internet based firm, will be driven by:

- Internet Access and Usage: Internet usage in developing economies rose to 51.0% in 2015, from 45.0% in 2013, and is fast approaching the global median of 67.0%, which creates a huge opportunity for e-commerce based platforms, and,
- Ease of Access to Smartphones: Statistics show that smartphone ownership rates in developing countries are fast rising towards the global median of 43.0%, at 37.0% as at 2015 as smartphones become cheaper with each passing year.

CDC is well known for its equity investments in African companies, being amongst the largest investors in private equity funds in Africa, and currently being present in 32 out of 54 countries in the continent. The investment in AIG comes after its recent announcement to invest USD 140 mn in ARM Cement in a bid to support growth in East Africa.

German Investment and Development Corporation (DEG), an investment fund based in Germany, has acquired an additional 5.4% stake in Zep-Re for Kshs 1.4 bn, increasing its total stake to 14.9%, valuing the re-insurance firm at Kshs 25.9 bn. Zep-re is a re-insurance firm based in Nairobi, and offering re-insurance services to insurance companies in East and Southern Africa. To facilitate this injection of new capital, new shares were created; a move that Kenya Re was trying to avoid when it acquired an additional 4.4% stake at Kshs 1.3 bn in June to increase its total stake to 19.9%, and maintaining its position as the single largest investor in Zep-Re. The capital acquired is meant to be used in: (i) expanding its business and realizing growth through enhancement of its operations in a bid to attain a stronger international rating as a re-insurer, and (ii) widening its agenda for development across COMESA member states. DEG is renowned for its developments in financial institutions and its investments in developing countries largely in the financial sector. Zep-Re has a dynamic team of shareholders consisting of 6 governments, 12 private companies, 12 re-insurance and insurance companies and 3 regional organizations. Among other organizations looking to own a share of Zep-Re include International Finance Corporation (IFC) which intends to buy an 11.0% stake at Kshs 1.9 bn. This will result in the issuance of new shares further diluting the other stakeholders. Kenya Re, one of the largest stakeholders has witnessed dilution from 20.7% to 16.0% in just 2-years.

Real Estate

Commercial Bank of Africa (CBA) announced its partnership with Bamburi Cement to finance mortgage borrowers, with the amount of each individual mortgage to be determined by the house typology that the buyer chooses. The housing units that will be constructed by Koto Housing using the Expanded Polystyrene Panel (EPS) technology will be completed within 30 to 45 days, with Bamburi providing the cement in the construction. Homebuyers will choose a house design from 30 architectural drawings and have their units completed even before they make their first loan repayment. The move seeks to solve the housing deficit approximated to be about 200,000 housing units per year as well as encourage mortgage uptake, with current number of active mortgage account less that 25,000. The house prices range from Kshs 0.5 mn to Kshs 4.5 mn for a one roomed and a 4-bedroomed house, respectively, with a maximum payment period of 25-years.

Assuming an interest rate of 18.0% p.a. with a maximum repayment period of 25-years, a buyer wishing to buy the one-roomed unit will have to make a monthly payment of approximately Kshs 7,600, whereas one opting for a 4-bedroomed house under the same arrangement will make monthly payments of approximately Kshs 68,300. Bamburi Cement will offer site-support for all the units developed under this project and hence the homeowners will not have to visit architects, regulatory authorities or be at the construction sites. Generally, this arrangement is affordable to a majority of the newly employed who earn as little as Kshs 25,000 net pay, meaning that 30% of their monthly earnings will be adequate to service the mortgage loans for a single roomed house. However, what is not clear to the market is (i) the location where this product will be rolled out to the market, and (ii) the size of the units to be developed, to enable buyers to understand their pricing point on a square metre basis.

Developers are now targeting to put up retail developments in the counties so that they tap into the rising disposable incomes in the counties that will attract shoppers into the malls. This comes after the possibility of oversupply of mall space in some nodes evidenced by low uptake. According to our retail report, Mt. Kenya Region outperformed the Nairobi Metropolis with a yield of 10.1% against 10.0%. The rate of urbanization at 4.3% is also another factor that cannot be overlooked, since other towns apart from Nairobi are also expanding in terms of population and consequently targeting the middle income earners.

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